2018 Mid-Year Review

Key Takeaways

U.S. equity markets managed a small gain in June led by small cap stocks. In the second quarter U.S. stocks surged past foreign developed stocks by 4.9% and emerging markets by 11.6%, taking back most of what they lost to overseas markets in 2017. U.S. small cap indices, such as the S&P 600 and the Russell 2000, set all-time highs in June. Year-to-date the S&P Small Cap Index has outperformed the S&P 500 by 6.7%.

International developed markets lost 1.2% for the month and for the quarter as the rising dollar, concerns about higher interest rates, and trade uncertainty weighed on markets. Emerging markets fell dramatically for the same reasons, down 4.2% for the month and 8.0% for the quarter.

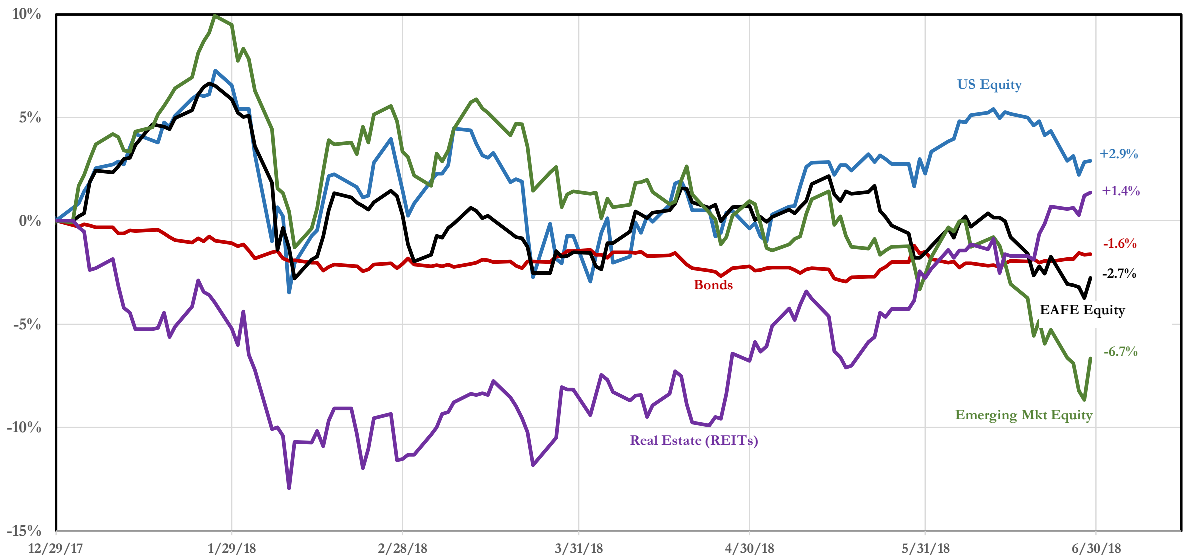
U.S. bond markets finished June and the quarter largely unchanged. Thirty-year Treasuries ended below 3.0%. Overseas bond markets generally fell in price, especially in more vulnerable emerging markets.

Real estate returns outpaced all asset categories in the second quarter, continuing their recovery from an early-year sell-off.

Table 1: Benchmark Index Performance as of June 29, 2018

Benchmark Index	***1 Mo***	***3 Mo***	***YTD***	***2017***
Domestic Equities (S&P 1500 Composite)	0.62%	3.65%	2.9%	21.1%
International Developed Equities (MSCI EAFE)	-1.22%	-1.24%	-2.7%	25.0%
Emerging Market Equities (MSCI EM)	-4.15%	-7.96%	-6.7%	37.3%
Fixed Income (Bloomberg Barclays US Aggregate)	-0.12%	-0.16%	-1.6%	3.5%
US Real Estate (S&P US REIT Index)	4.26%	10.37%	1.4%	4.3%
Global Equities (MSCI ACWI)	-0.54%	0.53%	-0.4%	24.0%

Chart 1: Market Index Performance through June 29, 2018



Overview

U.S. equities raced past international equities in the second quarter of 2018, outperforming international developed markets by 4.9% and emerging markets by 11.6%. A stronger dollar propelled US markets as the dollar increased 5.5% vs. the euro, 6.3% vs. the pound, 4.3% vs. yen, and 5.5% against China's renminbi. Small cap US stocks led the market as both the Russell 2000 and the S&P 600 posted all-time highs during the quarter while the S&P 500 ended June 5.4% short of January's all-time high. Emerging market economies suffered the most against the stronger dollar, higher U.S. interest rates, and trade fears. Eleven of the 24 emerging market countries experienced stock market declines in excess of 10% during the second quarter with declines in Brazil and Turkey in excess of 25%. The yield curve was largely unchanged during the month. Real estate was the best performer going into the end of the quarter as range-bound long interest rates and strong economic fundamentals helped REITs recover early-year losses.

Near the end of May we chose to reduce exposure to emerging market equities and, to a lesser extent, to developed market equities. We are concerned about the impact of rising interest rates and a stronger dollar on emerging market economies. As rates rise in the US, foreign central banks have been forced to keep pace by raising interest rates to prop up their currencies against the dollar. Those rate increases are problematic for countries with higher debt burdens and for countries with less foreign currency reserves. Given the strong international market performance in 2017, we are comfortable holding back on international asset allocations. We also recognize that international stocks are now significantly cheaper relative to US stocks and we may add back some exposure to take advantage of those cheaper assets.

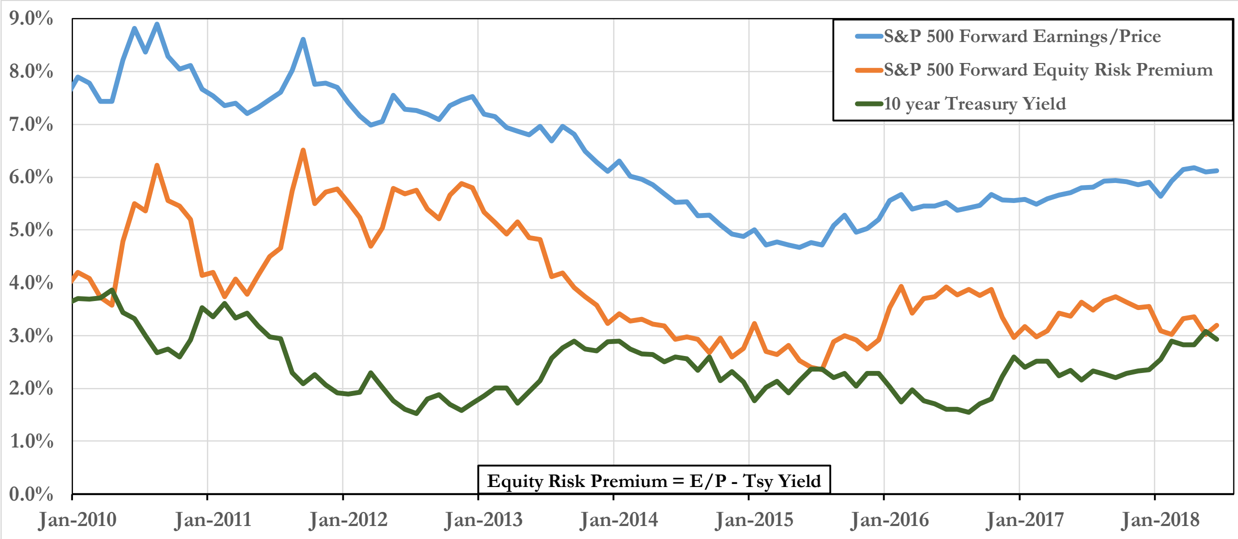
U.S. Market Review

In the second quarter of 2018 US equities were led by small cap stocks, growth stocks, energy stocks, and real estate. Small caps were helped by a lack of exposure to weak international markets as they generally trade better than large caps when foreign markets are under pressure. Technology shares have been led by strong fundamentals including continued strong earnings growth. Technology shares, while fundamentally expensive, are still nowhere near the exceptionally strong valuations experienced during the tech boom of 2000. Energy has surged forward with oil up to $74.15 at month end.

Market fundamentals are strong. Chart 2 below shows a breakdown of the equity risk premium calculated from the "Earnings/Price" less the 10-year Treasury yield. Note that "Earnings/Price" is the inverse of the Price/Earnings ratio and it describes the current earnings return on all S&P 500 stocks. This graph shows that the stocks are about the cheapest they have been in about 4 years based on the Earnings/Price ratio but relatively expensive on an equity risk premium basis.

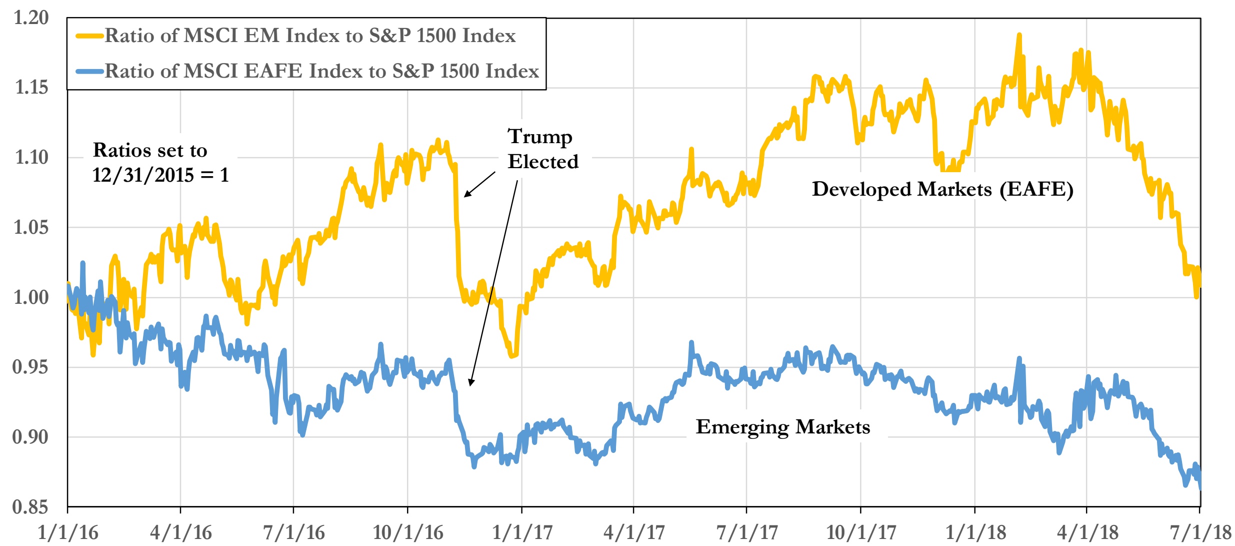
We view the US equity market as cheap based on our calculated forward P/E ratio of 16.3x. We have generally been long technology shares and small cap shares in most of our client portfolios and we are currently maintaining those modest overweights.

Chart 2: U.S. Equity Relative Value Metrics through June 29, 2018



Source: US Treasury, S&P Indices, Concho Inv Adv

Chart 3: U.S. Equities Outperform Foreign Equities in the Second Quarter: Asset Exchange Rates through June 29, 2018



Source: S&P, MSCI, Author's Calculations

International Equity Markets

International developed equity markets as represented by the MSCI EAFE Index were down 1.2% for the month and 1.2% for the second quarter. European economies are growing but growth rates have not been as fast as expected this year. The drama surrounding Italy's potential exit from the European Union quickly faded away in early June. However, German 10-year Bunds are back down to the 0.30% range (from 0.60% in May before the Italy crisis) which indicates that investors are wary of taking on additional risk . The

European Central Bank announced that asset purchases or "quantitative easing" will end this year and they also communicated that short-term interest rates will not rise until 2019. After dropping from mid-April through the end of May, the euro and most other developed currencies were largely unchanged in June versus the dollar. Ongoing international trade and tariff disputes increased uncertainty and contributed to the risk-off environment in developed markets. As Chart 3 shows, U.S. markets have rallied against their foreign counterparts in the second quarter of 2018. This rally is due to rising interest rates and the strength of the dollar, Trump's tariff efforts, and disappointing economic numbers in Europe.

Emerging Markets

Emerging market equities lost 4.2% in June and were down a total of 8.0% in the second quarter, by far the worst performing asset class. Eleven of the 24 emerging market countries experienced stock market declines in excess of 10% during the second quarter with Brazil and Turkey leading the way with stock market declines in excess of 25%. Rising rates in the US and a stronger dollar have pushed foreign governments to react by increasing interest rates in local markets and by selling reserves to prop up their currencies. These actions are causing pain in the more fragile emerging market economies, especially those countries with large debt balances and small foreign currency reserves.

We have always been concerned about China's huge credit expansion since the US financial crisis. Most market participants are quite aware of China's huge debt expansion in the last 10 years but the question is can they handle the larger debt? Recent developments certainly complicate their efforts, including (1) increasing interest rates, (2) a weaker currency, which is especially a problem for dollar-denominated debt obligations, (3) trade wars that reduce China's competitiveness, and (4) slowing economic growth. We are watching for events that might push China's credit problem into a larger crisis.

Bond Market Review and Outlook

June was a surprisingly quiet month in fixed income markets after a more tumultuous May. Yields on the short and long end of the curve finished the month within a couple of basis points of where they started the month. Intermediate term yields were up to 10 bps higher. The 30-year bond finished below 3% at 2.98%. Legislation enacted as a part of the 2017 tax cuts has made it much more attractive for certain defined-benefit plans to pay for retirement benefits prior to September 2018. The result is abnormally high demand for long Treasury debt, which we believe has kept long Treasury yields abnormally low. Also, strong economic growth will keep the FOMC on track for four rate hikes this year with quarter-points expected in September and December. Given our outlook, we are generally short duration in our bond allocations.

Real Estate Market Review and Outlook

Real estate markets continued their recovery off their February lows. REIT shares recovered in the second quarter of 2018 as interest rate fears faded. REITs traded down 9.0% in the first quarter of 2018 only to trade up 10.4% in the second quarter. We believe higher interest rates are a concern for real estate markets and we are either market weighted or underweight in our real estate allocations.

Ed Yale, CFA

President and Chief Investment Advisor

July 2018